

GAO

Report to the Chairman, Subcommittee
on Oversight of Government
Management, Committee on
Governmental Affairs, U.S. Senate

July 1993

FEDERAL TRADE COMMISSION

Enforcement of the Trade Regulation Rule on Franchising



Human Resources Division

B-248905

July 13, 1993

The Honorable Carl Levin
Chairman, Subcommittee on
Oversight of Government Management
Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

This report responds to your request for information on the Federal Trade Commission's (FTC) enforcement of its trade regulation rule on franchising (hereafter called the franchise rule).¹ FTC's rule requires franchisors to give prospective franchise purchasers financial details about the business and explain the arrangements in the franchise agreement. FTC enforces the franchise rule as part of its consumer protection mission.

You asked that we obtain the following information about FTC's franchise rule: (1) the number of franchise rule investigations and court cases started during fiscal years 1989-92; (2) enforcement problems, such as case processing delays, that may exist at headquarters or FTC regional offices; (3) FTC's effectiveness in working with states to enforce franchise rules and laws; and (4) possible revisions to regulating franchises, such as those contained in legislation proposed during the 102nd Congress.² You also asked for information relating to the outcomes of investigated and litigated complaints, the types of complaints filed, the kinds of franchisors that were taken to court, and enforcement activities in FTC's Atlanta Regional Office.

To respond to your questions, we obtained data and discussed these issues with officials from FTC's Division of Marketing Practices in the Bureau of Consumer Protection, its Office of the General Counsel, and FTC's Atlanta and Cleveland Regional Offices. We obtained information and documentation from state franchise disclosure enforcement officials in five states—California, Illinois, Maryland, New York, and Virginia. We also contacted officials in the International Franchise Association, the National Association of Attorneys General, and the North American Securities Administrators' Association for information about franchising issues and

¹FTC issued a trade regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" on December 21, 1978. The rule became effective October 21, 1979, and is generally referred to as the franchise rule. Under the Federal Trade Commission Act, trade regulation rules have the effect of law.

²H.R. 5232, the Federal Franchise Disclosure and Consumer Protection Act, and H.R. 5233, the Federal Fair Franchise Practices Act. Neither bill became law.

enforcement activities. See appendix I for more details on our scope and methodology.

On September 24, 1992, we discussed the results of our work with your office and agreed to obtain more details about franchisors that FTC had prosecuted for franchise rule violations. This report summarizes the information provided at that meeting and the additional information we obtained at your office's request.

Background

Franchising is a significant activity in the U.S. economy. According to the International Franchise Association, more than 542,000 franchising outlets operated in the United States in 1991, accounting for an estimated \$758 billion in sales, 35 percent of our nation's retail sales of goods and services. Congressional hearings in 1990 and 1991 identified continuing concern over potential problems with franchising, such as the adequacy of information that franchisors provide prospective franchisees during presale discussions.

In 1950, fewer than 100 companies used franchising in their marketing operations. By 1960, more than 900 companies used franchises, involving an estimated 200,000 franchise outlets. Rapid franchise expansion continued during the 1960s, and federal and state governments recognized the need to protect potential franchise purchasers. This expansion included many franchise offerings that were hastily structured, ill-conceived, and poorly capitalized. In the 1970s, a growing number of public complaints, class-action law suits, and business failures prompted some states to pass laws regulating franchise sales. In addition, in 1978, FTC issued its franchise rule.

Fifteen states have specific franchise sale disclosure laws to protect franchise purchasers in addition to the federal franchise rule. Like the federal rule, these state laws require franchisors to provide franchisees with certain information before contracting for a franchise purchase or sale. Other states protect potential franchisees under general consumer protection, fraud, or securities transaction laws. Some states place responsibility for enforcing consumer and franchisee protection laws with their attorneys' general offices. Thus, in cases of alleged franchisor impropriety, franchisees may have recourse under state law, federal law, or both.

The investigative process under FTC's franchise rule involves four major phases: (1) receiving complaints and inquiries about franchisor actions, (2) preliminary screening of complaints, (3) conducting initial phase and full phase investigations, and (4) taking action against franchisors or closing cases with no action against franchisors. FTC may begin investigations based on information from external sources, such as consumer complaints, or from internal actions, such as FTC self-initiated inquiries. Investigations may result in such actions as FTC (1) filing, via the Department of Justice, a consent decree or a complaint in court that may lead to an eventual judicial action against a franchisor or (2) closing the case with no action against the franchisor.

FTC's Bureau of Consumer Protection enforces the franchise rule. The Bureau spent an average of 15 workyears, or about 8 percent of its approximately 200 workyears, on franchise rule activities and enforcement during the 3 most recent fiscal years (1989-91) for which complete data were available at the time of our review.

Results in Brief

FTC received more than 1,360 consumer complaints during fiscal years 1989-92, and began 78 franchise rule and business opportunity investigations during that period. Of the 78 cases, FTC filed 14 cases in court against alleged rule violators, closed 31 cases, and 33 cases remained under investigation as of September 30, 1992. During fiscal years 1980-88, the FTC filed suit in 30 cases. FTC has had a high success rate with franchise rule cases brought to court; all litigated cases have resulted in some federal court action against franchisors.

FTC has limited enforcement resources. As a result, some potentially meritorious cases may not get investigated or litigated. Also, the process can be slow. In half of the 44 franchise rule cases FTC litigated, consumers had to wait more than 19 months for FTC to bring the case to court. However, we found no major differences in case processing times for cases filed in court during 1989-92 when compared with times for cases filed during 1980-88.

State consumer protection and franchise regulatory officials in five states we contacted said that their working relationships with FTC were effective in terms of information-sharing, case referrals, coordination, and joint federal-state efforts when appropriate. Likewise, FTC staff told us that they consider their working relationships with the states to be effective.

Many bills introduced in the Congress since 1979 would have revised the current law. These bills often included a provision that would have given franchisees a legal right to sue a franchisor. In franchise rule cases, FTC brings suit only on behalf of the federal government, not as a representative of individuals who may have been adversely affected. In some cases, however, FTC obtains redress for franchisees. (See app. IV.) Proponents and opponents of proposals to allow franchisees to sue franchisors directly on their own behalf agree that such a provision would be a significant departure from current law.

Principal Findings

FTC Investigates and Litigates Relatively Few Franchise Rule Cases

Each year FTC receives hundreds of franchise rule complaints, but it opens relatively few investigations and brings even fewer cases to court. FTC follows a four-step process to investigate alleged violations of the rule. The process ranges from an initial screening to a full phase investigation. (See app. II for details.) FTC uses a number of potential investigation sources. It actively seeks out situations in which rule violations may occur, such as during franchise trade shows and in franchisor advertising. FTC also receives complaints about alleged violations from consumers, franchisor competitors, and state and local governments.

Outcomes from full phase investigations can range from FTC closing the case with no further action to FTC filing complaints in court and obtaining judgments against violators. (See app. III for details about alleged violations in FTC's 44 filed cases and app. IV for details about outcomes in those cases.)

During fiscal years 1989-92, FTC opened 78 franchise rule investigations. Of these, 14 (18 percent) resulted in judicial action, 31 (40 percent) had been closed, and 33 (42 percent) were still being investigated at the end of fiscal year 1992.³

³During fiscal years 1990-92, FTC opened investigations on 54 cases, or about 4.0 percent of 1,363 complaints it received. Data on fiscal year 1989 franchise rule complaints received were not available. The 1,363 complaints represented about 1.1 percent of the total consumer complaints FTC received during the 1990-92 period. In contrast, FTC during the same period received more than 24,000 consumer complaints involving the Fair Credit Reporting Act and about 5,800 relating to the Mail Order rule.

Some Cases Take Years to Resolve

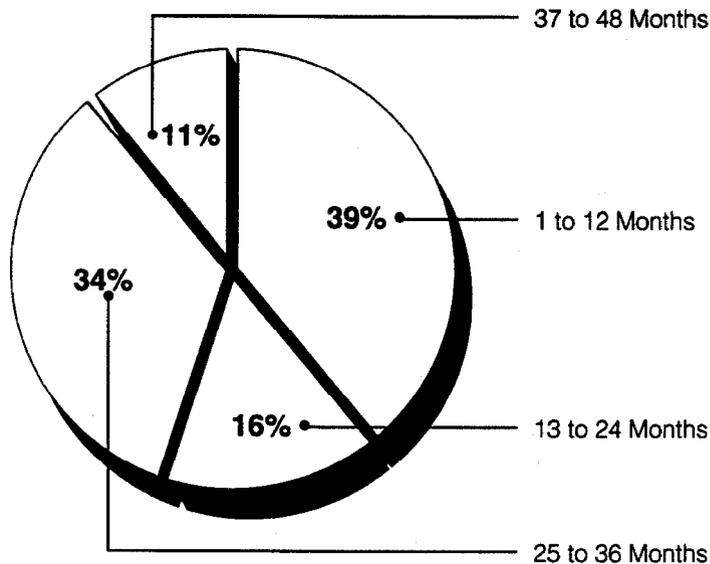
FTC has limited resources to devote to franchise rule enforcement.⁴ Given the limited number of cases it can investigate and litigate with these resources, as well as its other enforcement responsibilities, FTC acknowledges that its franchise rule strategy results in some potentially meritorious cases not being pursued and some victims not being helped, at least not by FTC.

Some FTC franchise rule court cases take years to resolve, such as 4 cases we identified in the Atlanta and Cleveland Regional Offices. FTC filed half of the 44 cases it decided to litigate during 1980-92 within 19 months from its decision to investigate. We found no major differences in FTC's processing time for franchise rule cases filed in court when we compared cases filed in more recent years with those filed earlier.

Within 1 year from the time it began an initial phase investigation, FTC filed 43 percent of its court cases (6 of 14) during 1989-92, compared with 37 percent of cases (11 of 30) filed during 1980-88. Over all 12 years, FTC filed 39 percent (17 of 44) of all court cases within 1 year from the time of its decision to investigate. (See fig. 1.) Additional details of our comparisons appear in appendix V. We did not analyze timeliness for cases with outcomes other than court filings.

⁴FTC is responsible for enforcing a variety of federal antitrust and consumer protection laws. FTC used about 2 percent of its staff resources on franchise rule activities and enforcement during fiscal years 1989-91 (the 3 most recent complete fiscal years during our review for which data were available). This 2 percent of FTC's total was about 8 percent of all Bureau of Consumer Protection workyears spent during that time.

Figure 1: Time From Investigation Start to FTC Court Filing for All 44 Cases Filed (Fiscal Years 1980-92)



FTC uses a selective approach to franchise rule enforcement. That is, it generally pursues those cases that it believes have the greatest deterrent effect for potential violators or the greatest likelihood of financial recovery for franchisees. FTC's selective approach to enforcement has produced a high success rate for litigated cases. All litigated cases have resulted in such action as court injunctions; franchisor asset freezes; civil penalties against franchisors; monetary redress for investors; or other sanctions, generally for subsequent violations, such as franchisor imprisonment.⁵

In 1991, FTC acknowledged in testimony before the House Committee on Small Business that this selective approach means that it (1) does not pursue some potentially worthy franchise complaints and (2) cannot help many victims with meritorious complaints. Given FTC's limited resources, its procedures and priorities for screening complaints, selecting cases for investigation, and choosing cases to pursue in court appear reasonable.

⁵Courts may issue asset freeze orders that prevent those assets from being sold, transferred, or otherwise disturbed until further court action. Assets frozen can include both corporate and personal assets, including real and personal property, of key officers and directors.

FTC and States Describe Working Relationships as Effective

State consumer protection and franchise regulatory officials said they consider their working relationship with FTC to be effective. When we contacted 5 of the 15 states that have state franchise disclosure laws, state officials in the 5 states told us that their working relationships with FTC were effective in terms of information-sharing, referrals, coordination, and joint efforts, when warranted. (Selected details about those states with franchise disclosure laws appear in app. VI.)

Officials in the 5 states commented favorably about such matters as complaint referrals from FTC to the states and information sharing about past or potential franchise rule violators. FTC officials also attend and participate with state officials in professional association meetings sponsored by the International Franchise Association, the National Association of Attorneys General, and the North American Securities Administrators' Association.

FTC officials at headquarters and in the Atlanta and Cleveland Regional Offices cited several examples of ongoing federal-state coordination in franchise rule enforcement. These included: (1) FTC attendance and presentations at meetings with state enforcement officials throughout the year; (2) FTC participation with states in joint enforcement sweeps at trade shows to identify and shut down franchise rule violators; (3) FTC collaboration with states in preparing an enforcement handbook for eventual distribution to all states; and (4) periodic referrals of complaints to states for their followup under state laws. Comments from FTC, state, and professional association officials we contacted indicate general satisfaction about FTC's working relationships with the states.

Proposed Legislative Provisions Could Have Been Significant

Attempts to regulate franchising through proposed federal legislation have generally been unsuccessful. Proposals would have affected franchisors, franchisees, and various aspects of their relationships, such as the type of information and the amount of detail franchisors would provide franchisees before contracting to sell. The topic most often included in proposed federal legislation since the 1960s involves giving franchisees the legal authority to sue franchisors directly on their own behalf for violation of the franchise rule.

Two bills introduced during the 102nd Congress would have made a potentially significant revision to current franchise regulatory practice. These bills—H.R. 5232 (Federal Franchise Disclosure and Consumer Protection Act) and H.R. 5233 (Federal Fair Franchise Practices

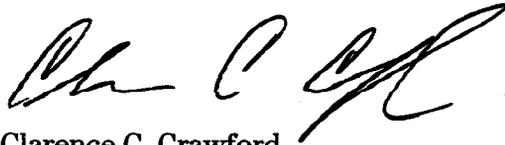
Act)—would have given franchisees the legal right to sue franchisors for violations of a range of consumer protection, disclosure, and fair practices provisions cited in the bills. Franchisees do not currently have the right under the law to sue franchisors for violations of the franchise rule. FTC brings suit only on behalf of the federal government, not as a representative of individuals who may have been adversely affected.

Allowing franchisees to sue franchisors would have addressed a long-standing criticism of the current law's limitations. Federal courts have historically rejected franchisees' attempts to sue franchisors under the current law, despite the fact that the FTC expressed the view at the time the rule was issued that the courts should permit private actions for violations. The current law as applied deprives franchisees of the right to pursue their own complaints for violations of the franchise rule. Consequently, franchisees must seek recourse through (1) FTC's bringing a complaint in federal court or other FTC actions against franchisors—such as negotiated consent decrees, (2) state enforcement action, or (3) private action under other consumer protection or fraud statutes or a breach of contract action under the franchise agreement.

Proponents of a private right to enforce the franchise rule claim that this would allow franchisees to (1) overcome such impediments as limited FTC staff resources to pursue the franchisee's case and (2) proceed independently, if necessary, against franchisors. Opponents of the private right to sue claim that public policy regarding franchise rule enforcement is more appropriately effected through FTC-initiated cases using a federal perspective than through franchisee-initiated cases. Opponents also point out that the cost of suing a franchisor may be prohibitive for franchisees who may already be in financial difficulty, thereby eliminating any effective pursuit or recourse under a right-to-sue provision.

We discussed the results of our work with responsible agency officials and have incorporated their comments where appropriate. We believe that written agency comments were not necessary in this instance. We are sending copies of this report to the Chairman of the Federal Trade Commission and other interested parties. We will also make copies available to others on request. If you have any questions or wish to discuss the information provided, please call me on (202) 512-7014. Other major contributors to this report are listed in appendix VII.

Sincerely yours,



Clarence C. Crawford
Associate Director, Education
and Employment Issues

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Abbreviations

FTC Federal Trade Commission

Objectives, Scope, and Methodology

To answer the Chairman's questions about number, type, and status of investigations and court cases, we interviewed officials in, and obtained information from, FTC's Division of Marketing Practices in the Bureau of Consumer Protection and its Office of the General Counsel.¹ As requested, we focused on investigations and court cases started during fiscal years 1989-92. We obtained and analyzed (1) lists of all such investigations and court cases, (2) profiles of key dates and events associated with each case, and (3) summaries of the cases that FTC filed in court.

To address the questions about case processing delays and possible enforcement problems at FTC headquarters or regional offices, we (1) reviewed FTC procedures for conducting investigations; (2) interviewed officials at FTC headquarters and its Atlanta and Cleveland Regional Offices; and (3) analyzed case processing times for two categories of cases: all 44 cases filed in court during fiscal years 1980-92 and 64 cases started during fiscal years 1989-92, but not filed in court. Of the 64 cases not filed, 31 had been closed and 33 remained open as of September 30, 1992.

We did not analyze case processing times for cases started before fiscal year 1989 that were not filed in court. We did, however, include cases filed in court from 1980-88 in our comparisons because they represent 68 percent of all court cases filed after FTC implemented the franchise rule in October 1979.

We used average time, median time, and range of time from consumer complaint to compare processing times for the 44 court cases. (See app. V.)

To answer the Chairman's questions about FTC's effectiveness in dealing with the states, we interviewed FTC headquarters and Atlanta and Cleveland Regional Office staff about their working relationships and coordination with the states. We judgmentally selected 5 of the 15 states that have state franchise disclosure laws and interviewed franchise disclosure enforcement officials in those 5 states about their working

¹The Office of the General Counsel provided requested data prepared by the Division of Marketing Practices in the Bureau of Consumer Protection. Some of these data are nonpublic and confidential and pertain to ongoing investigations. Examples of such restricted information include the names of franchisors under investigation, the dates of key events in ongoing investigations, and the status of open cases. Although we had access to such data, we agreed that this report and any briefings or other data we gave to the requester would contain no such restricted information.

relationships and coordination with FTC.² We also contacted officials in professional associations including the International Franchise Association, the National Association of Attorneys General, and the North American Securities Administrators' Association for their views about FTC's working relationships and coordination with the states.

To answer questions about possible revisions to the franchise rule, we conducted a literature search of franchising articles, documents, and publications from government and private sector sources. We reviewed the legislative histories of two bills affecting franchising that were introduced during the 102nd Congress.³ We also asked FTC headquarters and regional officials, state franchise law enforcement officials, and professional association representatives about franchise rule revisions and alternatives.

We discussed the results of our work with responsible agency officials and have incorporated their comments where appropriate. We believe that written agency comments were not necessary in this instance. We conducted our work between June 1992 and May 1993 in accordance with generally accepted government auditing standards.

²We selected California because it was the first state to enact a state franchise disclosure law and, thus, has the most experience with regulating franchising. We chose Illinois and New York from among a number of states suggested to us by a professional association official as being states with a good enforcement reputation. We selected Maryland and Virginia because we wanted to interview officials in one state each from those under the jurisdictions of the two FTC regional offices we contacted during our study—Cleveland and Atlanta, respectively.

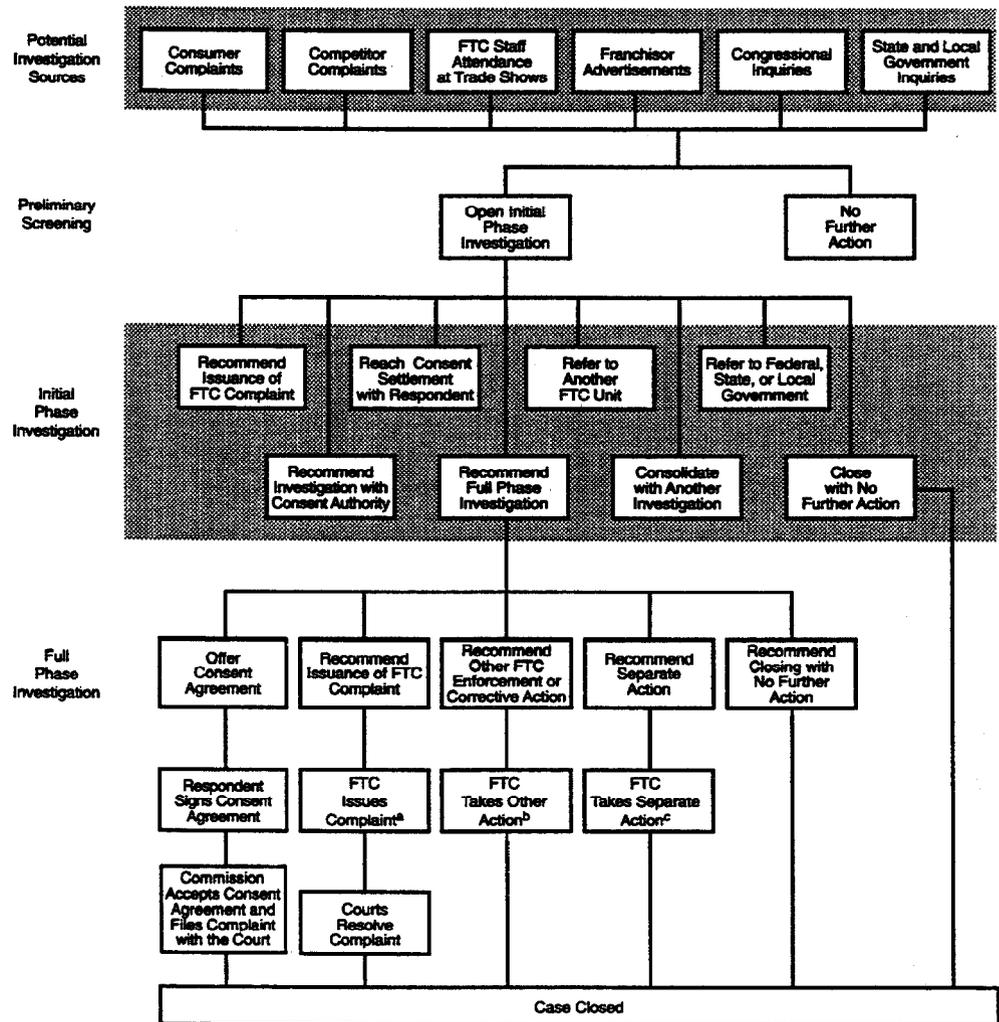
³H.R. 5232, the Federal Franchise Disclosure and Consumer Protection Act, and H.R. 5233, the Federal Fair Franchise Practices Act. Neither bill became law.

FTC Franchise Rule Investigative Process

FTC protects consumers against fraudulent practices by enforcing consumer protection laws and FTC trade regulation rules that have the force of law. One such example is the 1979 Franchise and Business Opportunities Rule. FTC follows a four-step process to investigate alleged violations. (See fig. II.1.)

**Appendix II
FTC Franchise Rule Investigative Process**

Figure II.1: FTC Franchise Rule Investigative Process



^aFTC issues a complaint on behalf of the federal government rather than as a representative of individual or multiple complainants.

^bOther actions include (1) trade regulation rulemaking, (2) issuing a staff report, (3) promulgating an industry guide, (4) FTC Act administrative complaint proceedings, (5) enforcing orders against nonrespondents, (6) instituting judicial action for civil penalties, or (7) recommending an FTC compliance investigation.

^cSeparate action may include a proposal for an industry study or a recommendation for legislation.

Source: GAO derived from FTC Operating Manual, Chapter 3, Investigations.

**Appendix II
FTC Franchise Rule Investigative Process**

First, FTC headquarters and regional offices identify possible franchise violations. Second, FTC screens all complaints to determine whether there is a sufficient basis to open an initial phase investigation. If not, FTC takes no further investigative action. If FTC finds a sufficient basis, it proceeds. Third, FTC initial phase and full phase investigations seek to gather sufficient evidence to decide among several possible courses of action. Fourth, FTC takes such actions as (1) reaching consent agreements with alleged violators, (2) referring the matter to other FTC units or other government agencies, (3) filing a complaint in court against an alleged violator, and (4) closing the case with no further action.

Franchise complaints originate throughout the country. Depending on such factors as FTC headquarters and regional workload, staff subject matter expertise at different locations, and location of franchise headquarters, FTC regional offices may investigate complaints originating from regions of the country other than those for which they are routinely responsible.

Table II.1: FTC Franchise Rule and FTC Act Section 5 Cases Filed in Court, by Year and by Location of Investigating Offices (1980-92)

Calendar year	Total cases filed	Investigating offices ^a
1980	1	San Francisco
1981	2	Denver (2)
1983	6	Atlanta; Chicago; Washington, D.C. (3); New York
1984	2	Washington, D.C.; New York
1985	4	Cleveland; Washington, D.C. (2); Denver
1986	1	New York
1987	3	Cleveland (2); Washington, D.C.
1988	3	Denver; San Francisco; Seattle
1989	7	Boston (2); Washington, D.C.; Denver (2); San Francisco (2)
1990	5	Washington, D.C. (2); Denver; New York; San Francisco
1991	2	Boston/San Francisco ^b (1); New York (1)
1992	8	Chicago; Cleveland; Dallas; Washington, D.C. (5)
Total	44	

^aIncludes FTC headquarters in Washington, D.C., and 10 regional offices (9 shown in table above, plus Los Angeles).

^bThese two regional offices jointly investigated one of the cases.

Alleged Violations and Number of Investors Affected in 44 FTC Franchise Rule or FTC Act Section 5 Complaints Involving Franchisors

Between the franchise rule's effective date in 1979 and the end of fiscal year 1992, FTC took 44 franchise rule cases to court. Of these, 42 involved allegations of franchisor misrepresentations, false claims or promises, or failures to disclose required information. FTC alleged violations in the 44 cases of either the franchise rule, section 5 of the FTC Act, or both. Most franchise rule violators also violate section 5 of the act. Section 5 declares unfair methods of competition and unfair deceptive acts or practices affecting commerce to be unlawful, and directs FTC to prevent such unfair methods, acts, and practices.

Table III.1: Summary of Alleged Violations and Number of Investors Affected

Case name and date FTC filed	Description of alleged violation	Investors affected
Franchise rule violation cases		
American Legal Distributors, Inc.; March 14, 1988	No rule compliance; misrepresentations in the sale of distributorships; false claims about earnings, exclusivity of territories, willingness to provide refunds, and low investment risk; failure to provide basic and earnings claim disclosure documents.	400
American Safe Marketing, Inc.; March 10, 1989	No rule compliance; false earnings claims; misrepresentations that investment was low risk and that defendant would secure accounts, pay sales commissions, and provide exclusive territories.	180
Claude A. Blanc, Jr.; June 16, 1992	No rule compliance; misrepresentations about earnings, location assistance, availability of medical insurance, minimum income, and refunds.	Unknown
Caribbean Clear, Inc.; June 9, 1992	Failure to provide basic disclosures; lack of reasonable basis and disclosures to substantiate income claims; failure to make required disclosures in advertisements making earnings claims; misrepresentations to consumers and potential franchisees about state health department approval of product.	165
Case Equipment Co., Inc.; July 11, 1989	No rule compliance; false claims about equipment capability and ease of operation; false promises that defendant would provide a list of customers or accounts; skills used to pose as satisfied investors.	3,750
Comprehensive Accounting Corp.; August 5, 1987	Marketing violations; misrepresentations about earnings, profits, and the number of franchisees that failed or left the system.	350
C.D. Control Technology, Inc.; June 28, 1985	No rule compliance; misrepresentations about earnings claims, exclusivity of territories, training, and technical support to be provided; shell dealers (company employees) used as references.	Unknown
Enamelcraft, Inc.; September 2, 1981	No rule compliance; misrepresentations about minimum earnings, merchandise quality, training and other assistance, and first year profit guarantees.	80
Fax Corp. of America, Inc.; March 19, 1990	No basic and earnings claim disclosures; failure to make disclosures required in media advertising with earnings claims; failure to make promised refunds; misrepresentations about availability of territory reservation deposit refunds and distributorship fees.	500

(continued)

**Appendix III
Alleged Violations and Number of Investors
Affected in 44 FTC Franchise Rule or FTC
Act Section 5 Complaints Involving
Franchisors**

Case name and date FTC filed	Description of alleged violation	Investors affected
Federal Energy Systems, Inc.; April 2, 1984	No rule compliance; misrepresentations about earnings, success, availability of starting inventory, company financing and lease assistance to franchisees' customers, ease of sales, exclusivity of territories, extent of company advertising, and refundability of deposits.	60
Ferrara Foods, Inc.; January 18, 1983	No rule compliance; misrepresentations about first year income, exclusivity of company's right to sell product, availability of national media advertising, management and marketing advice, and territory repurchase.	48
Intellipay, Inc.; August 5, 1992	No compliance with basic rule or earnings claim disclosure requirements; misrepresentations about potential income, minimum income, phone installation, company-provided training, and additional costs.	45
Investment Developments, Inc.; February 14, 1989	No rule compliance; false claims about earnings and company-provided assistance and false refund promises.	600
The KIS Corp.; November 29, 1988	No rule compliance; failure to provide basic and earnings claim disclosures; misrepresentations about earnings, equipment speed, ease of operation, and reliability, and financing terms.	6,000
Lady Foot International, Inc.; October 29, 1987	Disclosures delivered late or not at all; no list of franchisees or earnings disclosure; misrepresentations about earnings, nature and extent of assistance, and quality of inventory.	60
Leisure Time Electronics, Inc.; March 7, 1983	No rule compliance; misrepresentations about access to locations in national chains, availability of lists of good locations, machine maintenance and service ease, minimum profitability, machine conversion, territorial exclusivity, and FTC approval.	Unknown
Li'l Peach of Massachusetts, Inc.; July 5, 1983	Advertised earnings claims without required disclosure of the number and percentage of franchisees doing as well; failure to provide basic disclosure document and earnings claim document in some cases.	15
Lifecall Systems, Inc.; September 10, 1990	Failure to provide required information about nearest franchise locations; making minimal income claims with no reasonable basis; misrepresentations about franchise profitability, inventory delivery and replacement capability, ratio of sales to solicitations, and state and local registration requirements.	4,700
Marketing Associates, Inc.; July 9, 1981	No rule compliance; misrepresentations about earnings, machine delivery and location assistance, and availability of company-provided service and repairs.	40
McKleans, Inc.; November 14, 1989	False balance sheets and income statements in disclosure document; failure to provide earnings claim document and reasonable basis for claim; failure to provide promised refunds; misrepresentations about location and financing assistance, franchise repurchase and investment refunds, and risk of investment.	33
National Business Consultants, Inc.; April 19, 1989	No rule compliance; false promises of training and assistance; misrepresentations about earnings, territorial exclusivity, deposit refundability; use of paid skills to exaggerate reports of success as consultants.	500

(continued)

**Appendix III
Alleged Violations and Number of Investors
Affected in 44 FTC Franchise Rule or FTC
Act Section 5 Complaints Involving
Franchisors**

Case name and date FTC filed	Description of alleged violation	Investors affected
Perkits, Inc.; August 6, 1992	Failure to make timely disclosures; incomplete disclosures did not include required information about material litigation, true identities of corporate officers, or substantiation for earnings claims.	20
Philly Mignon International; January 17, 1984	Failure to provide complete and accurate information in disclosures; failure to provide documents at required times; failure to provide required earnings claim document; failure to include list of current franchisees; misrepresentations about success and earnings of existing franchises, start-up time, and company's ability to provide suitable locations, training, and management support.	Unknown
Royco Automobile Parts, Inc.; January 3, 1984	No rule compliance; misrepresentations about earnings, rate of return on investment, "no-risk" investment based on false promise to reimburse; use of shells who never invested to pose as investors.	80
H. N. Singer, Inc.; July 24, 1980	No rule compliance; misrepresentations about earnings, training, assistance and guidance, and quality of retail accounts to be provided.	60
William A. Skaife; February 1, 1990	No rule compliance; misrepresentations about earnings, refundability of deposits, and expert assistance; no reasonable basis for earnings claims made.	150
Stricker, et al.; October 31, 1990	Inaccurate, incomplete, and untimely disclosures; earnings claims without required disclosures or a reasonable basis; misrepresentations about identities of officers, directors, and principals of companies; false representations about company's financial condition; use of untruthful and inaccurate disclosure documents in five states; claims of timely location selection and product delivery; offers of exclusive territories; false earnings claims and false claims about companies' financial soundness and legitimacy; representations that (1) sales would improve with time, (2) products were generating acceptable sales levels elsewhere, (3) merchandise exchanges or new locations would improve sales, and (4) companies would remarket franchise if franchisee was dissatisfied.	250
Technical Communications Indus., Inc.; December 20, 1985	No rule compliance; misrepresentations about earnings, equipment to be provided, on-site training, exclusivity of territories, and marketing assistance.	100
Telecomm, Inc.; September 11, 1992	Failure to provide basic and earnings claim disclosure documents at times required; lack of reasonable basis for earnings claims.	8
Tiny Doubles Intn'l, Inc.; September 13, 1990	Failure to provide any of the disclosures required by the rule; lack of reasonable basis for earnings claims; misrepresentation that businesses being sold were not franchises requiring disclosure and misrepresentation about income of existing franchises.	25
Tuff-Tire America, Inc.; April 29, 1985	No rule compliance; misrepresentations about earnings, liability coverage, availability of on-site training, product performance and novelty, and refund availability in case of product failure.	87
U.S. Music Club, Inc.; January 13, 1988	Failure to provide basic disclosure document; unsubstantiated earnings claims; misrepresentations about earnings, number of persons willing to serve as sales distributors, refundability of initial investment, and exclusivity of territories; use of shells.	1,100
Value Investments, Ltd.; March 19, 1991	Various.	963

(continued)

**Appendix III
Alleged Violations and Number of Investors
Affected in 44 FTC Franchise Rule or FTC
Act Section 5 Complaints Involving
Franchisors**

Case name and date FTC filed	Description of alleged violation	Investors affected
Video Station, Inc.; May 31, 1983	No rule disclosures.	180
Whitehead, Ltd.; August 10, 1992	Failure to provide presale disclosure documents at required times; omitting required disclosures such as accurate audited financial statements and information about a legal judgment against defendants in a fraud action brought by former franchisees.	32
Why USA, Inc.; June 26, 1992	Failure to provide rule disclosures to some franchisees or to provide accurate information about identity of corporate officers and litigation in which they had been involved when investors received required disclosures.	Unknown
7-Day Appraisal Services, Inc.; April 26, 1989	No rule compliance; misrepresentations about earnings, approval and use of services by lenders, adequacy of training; providing errors and omissions about insurance coverage; use of skills as references.	50
FTC Act section 5 cases		
Academic Guidance Services, Inc.; July 16, 1992	Misrepresentations about substance and source of investor testimonials in promotional materials; overstating earnings potential, consumer response to mail solicitations, and services offered to investors.	18,000
Engage-A-Car Services, Inc.; September 24, 1986	Misrepresentations about franchise profitability, number of franchise failures, company capacity to provide financing and cars to fill lease orders sold by franchisees.	8,500
Kaplan, et al.; March 6, 1985	False claims about earnings, exclusive territories, training, product features, ease of finding customers, repurchase of product; use of skills as references.	120
Kitco of Nevada, Inc.; June 9, 1983	Misrepresentations about franchisor's purchase of all products made by franchisees, profitability, amount and duration of work for investors, frequency and method of payment for products received, nature and extent of services and assistance to be provided; use of skills.	20
Patriot Alcohol Testers, Inc.; July 9, 1991	Misrepresentations about accuracy of equipment, earnings, average income, maintenance, and availability of insurance to bars accepting the machines.	2,000
Rainbow Enzymes, Inc.; September 23, 1987	Misrepresentations about existence of a substantial established market, endorsements by major corporations and government agencies; failure to disclose bankruptcy of company.	2,000
T.B.A., Inc.; October 2, 1989	False representations that the product was valid; misrepresentations about FDA approval, product capability, and potential earnings.	580

Source: FTC, Division of Marketing Practices, Bureau of Consumer Protection.

Outcomes in 44 FTC Franchise Rule or FTC Act Section 5 Complaints Involving Franchisors

From 1980-92, FTC filed 44 franchise rule or FTC Act section 5 complaints in court that involved franchisors. Although FTC takes relatively few franchise rule cases to court, it has a high success rate when it does. All litigated cases have resulted in such actions as court injunctions, franchisor asset freezes, civil penalties against franchisors, monetary redress for investors, or other sanctions, such as franchisor imprisonment. The 44 franchise rule cases filed since 1980 have resulted in over \$37 million in consumer redress for more than 30,000 investors, more than \$3.8 million in civil penalties, 25 cases with franchisor asset freezes, and 2 cases of franchisor imprisonment.

Table IV.1: Summary of Outcomes

Case name (defendant)	Court injunction ^a	Asset freeze ^b	Civil penalty ^c	Monetary redress ^d	Other redress ^e
Franchise rule violation cases^f					
American Legal Distributors, Inc.	Y	Y	N	\$3,292,575	Prison
American Safe Marketing, Inc.	Y	Y	N	\$150,000	N
Claude A. Blanc, Jr.	P	Y	P	P	P
Caribbean Clear, Inc.	N	N	N	\$10,000	N
Case Equipment Co., Inc.	Y	Y	N	\$250,000	Y
Comprehensive Accounting Corp.	Y	N	N	\$3,500,000	N
Control Technology, Inc.	Y	Y	\$430,000	\$306,400	N
Enamelcraft, Inc.	Y	N	\$15,000	N	N
Fax Corp. of America, Inc.	N	Y	N	\$312,836	N
Federal Energy Systems, Inc.	Y	Y	\$1,610,000	\$3,000,000	N
Ferrara Foods, Inc.	Y	N	\$40,000	N	N
Intellipay, Inc.	Y	Y	N	N	N
Investment Developments, Inc.	Y	Y	N	\$9,800,000	N
The KIS Corp.	N	N	N	\$1,500,000	N
Lady Foot International, Inc.	Y	N	\$50,000	N	N
Leisure Time Electronics, Inc.	Y	N	\$157,500	N	Y
Li'l Peach of Massachusetts, Inc.	Y	N	\$10,000	N	N
Lifecall Systems, Inc.	Y	N	\$150,000	N	Y
Marketing Associates, Inc.	Y	N	N	\$400,000	N
McKleans, Inc.	Y	N	N	N	N
National Business Consultants, Inc.	Y	Y	N	N	N
Perkits, Inc.	P	P	P	P	P
Philly Mignon International	N	N	\$80,000	N	Y
Royco Automobile Parts, Inc.	Y	Y	\$400,000	\$567,000	N
H.N. Singer, Inc.	Y	Y	N	\$2,090,000	N

(continued)

**Appendix IV
Outcomes in 44 FTC Franchise Rule or FTC
Act Section 5 Complaints Involving
Franchisors**

Case name (defendant)	Court injunction^a	Asset freeze^b	Civil penalty^c	Monetary redress^d	Other redress^e
William A. Skaife	Y	Y	N	N	Y
Stricker, et al.	Y	Y	N	N	N
Technical Communications Indus., Inc.	Y	Y	\$25,000	\$26,795	N
Telecomm, Inc.	Y	N	N	N	N
Tiny Doubles Intn'l, Inc.	Y	Y	N	N	N
Tuff-Tire America, Inc.	Y	Y	\$885,000	\$1,445,019	Prison
U.S. Music Club, Inc.	Y	Y	N	\$322,755	N
Value Investments, Ltd.	Y	Y	N	P	P
Video Station, Inc.	N	N	\$55,000	N	N
Whitehead, Ltd.	P	P	P	P	P
Why USA, Inc.	Y	N	\$27,500	N	N
7-Day Appraisal Services, Inc.	Y	Y	N	\$55,000	N
FTC Act section 5 cases^f					
Academic Guidance Services, Inc.	Y	Y	P	P	P
Engage-A-Car Services, Inc.	Y	Y	N	\$1,630,000	N
Kaplan, et al.	Y	Y	N	N	Y
Kitco of Nevada, Inc.	Y	N	N	\$531,949	N
Patriot Alcohol Testers, Inc.	Y	Y	N	N	N
Rainbow Enzymes, Inc.	Y	Y	N	\$4,465,000	N
T.B.A., Inc.	Y	N	N	Y	N
Total	36 cases	25 cases	\$3,935,000	\$33,655,329	6 cases

Legend:

Y = Yes
N = No
P = Pending as of September 30, 1992

^aMay be a preliminary and/or a permanent injunction against franchise rule violations and misrepresentations in the offer or sale of any business venture, regardless of whether covered by the rule. (See note f.)

^bMay include both corporate and personal assets, including real and personal property, of key officers and directors.

^cUp to \$10,000 for each violation of the rule.

^dFor investors injured economically by a rule violation.

^eCourt may find it necessary to redress injury to consumers by such actions as rescission or reformation of contracts, return of property, or public notice of rule violation. Department of Justice may obtain criminal indictments that can result in prison sentences.

^fTable shows case status as of September 30, 1992. Between October 1, 1992, and May 27, 1993, FTC further resolved seven of these cases and filed another six cases.

Processing Times for Selected Categories of Cases (1980-92)

Key events (range of time being calculated)	64 cases started but not filed in court, 1989-92 ^a		14 cases started and filed in court, 1989-92	30 cases started and filed in court, 1980-88
	Open ^b	Closed		
Consumer complaint to end of initial phase investigation	Average: 238 days ^c	Average: 303 days ^d	Average: 190 days	Average: 268 days
	Median: 233 days ^c	Median: 238 days ^d	Median: 154 days	Median: 224 days
	Range: 54 to 458 days ^c	Range: 34 to 928 days ^d	Range: 43 to 413 days	Range: 6 to 698 days
Consumer complaint to end of full phase investigation	Not applicable because full phase is incomplete	Average, median, and range do not apply to the one case in this category (839 days)	Average: 541 days Median: 489 days Range: 110 to 1,061 days	Average: 615 days Median: 546 days Range: 54 to 1,415 days

^aThis group includes 31 cases closed during the period and 33 cases open at the end of fiscal year 1992, but excludes 14 cases started and filed in court during the period.

^bOpen as of September 30, 1992. Because the closing dates for open cases are unknown, comparisons between average, median, and range of time for open cases and closed cases are inappropriate.

^cAverage, median, and range calculations are for 17 of the 33 open cases; 16 of the 33 cases were still in the initial phase as of September 30, 1992.

^dOf 31 closed cases, 30 cases were closed during the initial phase investigation and 1 case advanced to a full phase investigation.

Franchise Regulation Provisions in Selected State Laws

State	Disclosure required ^a	Registration required ^b	Regulation statute ^c
California	Yes	Yes	Yes
Hawaii	Yes	Yes	Yes
Illinois	Yes	Yes	Yes
Indiana	Yes	Yes	Yes
Maryland	Yes	Yes	No
Michigan	Yes	No	Yes
Minnesota	Yes	Yes	Yes
New York	Yes	Yes	No
North Dakota	Yes	Yes	No
Oregon	Yes	No	No
Rhode Island	Yes	Yes	No
South Dakota	Yes	Yes	Yes
Virginia	Yes	Yes	Yes
Washington	Yes	Yes	Yes
Wisconsin	Yes	Yes	Yes
Totals	15	13	10

Source: Franchising in the U.S. Economy, Hearing before the Committee on Small Business, House of Representatives, Serial No. 101-79, September 27, 1990, pages 69, 70, and 109.

^aState franchise law requires the delivery of franchise disclosure documents to prospective franchisees before an offer to sell or the actual sale of a franchise.

^bState law requires registration of the franchise or the franchisor, as well as state review of the franchisor's offering circular that describes the franchise and its operations and contains information for the franchisee.

^cState law covers franchisor-franchisee relationship in conjunction with, or in addition to, disclosure and registration statutes. There are also 7 states with "relationship" statutes that specifically cover franchisor-franchisee relationships: Arkansas, Connecticut, Delaware, Mississippi, Missouri, Nebraska, and New Jersey.

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